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IN THE

Supreme Court of the United States

OCTOBER TERM, 1973

HARVEY ROSENBERG,

Petitioner,

v.

LEON D. LAFFAL, *et al.*,

Respondents.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

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CASE REPORTED BELOW

The opinion of the Court of Appeals was reported as *Laffal v. Rosenberg*, 489 F.2d 1272 (D.C. Cir. 1974). It is reprinted as Appendix A hereto. The opinion of the trial court (findings and conclusions) was unreported. It is reprinted as Appendix B hereto.

JURISDICTION OF THIS COURT

The jurisdiction of this Court in the present case is founded upon 28 U.S.C. §1254(1) (1970) which gives this Court authority to review, by writ of certiorari, the judgment of a United States Court of Appeals in a civil case.

The judgment in this case of the United States Court of Appeals for the District of Columbia Circuit was filed on January 22, 1974. A petition for rehearing or rehearing *en banc* was denied by the Court of Appeals in an order filed February 12, 1974.

QUESTIONS PRESENTED

1) Did the courts below err in their application of Maryland law (the governing law) with the result that the judgments of those courts are flatly opposed to Maryland law, to wit:

a) Did the courts err in ruling that certain shareholders were justified in not making a requisite demand upon the corporate directors and did the courts err in their failure to rule on the necessity of such demands?

b) Was the award of punitive damages herein contrary to Maryland law?

c) Was there error in including among sums computed as damages certain sums returned to three note holders as satisfaction of past due notes?

2) Was service of process herein improper under the Federal Rules of Civil Procedure so that Petitioner Rosenberg was never properly before the trial court?

3) Was the trial judge so biased and prejudiced against Petitioner Rosenberg as to deprive him of a fair trial and due process of law?

CONSTITUTIONAL PROVISIONS AND APPLICABLE FEDERAL RULES OF CIVIL PROCEDURE INVOLVED HEREIN

Fifth Amendment to the CONSTITUTION OF THE UNITED STATES

No person shall be held to answer for a capital, or otherwise infamous crime, unless on a presentment or indictment of a Grand Jury, except in cases arising in the land or naval forces, or in the Militia, when in actual service in time of War or public danger; nor shall any person be subject for the same offense to be twice put in jeopardy of life or limb; nor shall be compelled in any criminal case to be a witness against himself, nor be deprived of life, liberty, or property, without due process of law; nor shall private property be taken for public use, without just compensation.

Rule 4 FRCP

Rule 4. Process.

(a) Summons: Issuance. Upon the filing of the complaint the clerk shall forthwith issue a summons and deliver it for service to the marshal or to a person specially appointed to serve it. Upon request of the plaintiff separate or additional summons shall issue against any defendants.

(b) Same: Form. The summons shall be signed by the clerk, be under the seal of the court, contain the name of the court and the names of the parties, be directed to the

defendant, state the name and address of the plaintiff's attorney, if any, otherwise the plaintiff's address, and the time within which these rules require the defendant to appear and defend, and shall notify him that in case of his failure to do so judgment by default will be rendered against him for the relief demanded in the complaint. When, under Rule 4(e), service is made pursuant to a statute or rule of court of a state, the summons, or notice, or order in lieu of summons shall correspond as nearly as may be to that required by the statute or rule.

(c) By Whom Served. Service of all process shall be made by a United States marshal, by his deputy, or by some person specially appointed by the court for that purpose, except that a subpoena may be served as provided in Rule 45. Special appointments to serve process shall be made freely when substantial savings in travel fees will result.

(d) Summons: Personal Service. The summons and complaint shall be served together. The plaintiff shall furnish the person making service with such copies as are necessary. Service shall be made as follows:

(1) Upon an individual other than an infant or an incompetent person, by delivering a copy of the summons and of the complaint to him personally or by leaving copies thereof at his dwelling house or usual place of abode with some person of suitable age and discretion then residing therein or by delivering a copy of the summons and of the complaint to an agent authorized by appointment or by law to receive service of process.

(2) Upon an infant or an incompetent person, by serving the summons and complaint in the manner prescribed by the law of the state in which the service is made for the service of summons or other like process upon any such defendant in an action brought in the courts of general jurisdiction of that state.

(3) Upon a domestic or foreign corporation or upon a partnership or other unincorporated association which is subject to suit under a common name, by delivering a copy of the summons and of the complaint to an officer, a managing or general agent, or to any other agent authorized by appointment or by law to receive service of process and, if the agent is one authorized by statute to receive service and the statute so requires, by also mailing a copy to the defendant.

(4) Upon the United States, by delivering a copy of the summons and of the complaint to the United States attorney for the district in which the action is brought or to an assistant United States attorney or clerical employee designated by the United States attorney in a writing filed with the clerk of the court and by sending a copy of the summons and of the complaint by registered or certified mail to the Attorney General of the United States at Washington, District of Columbia, and in any action attacking the validity of an order of an officer or agency of the United States not made a party, by also sending a copy of the summons and of the complaint by registered or certified mail to such officer or agency.

(5) Upon an officer or agency of the United States, by serving the United States and by delivering a copy of the summons and of the complaint to such officer or agency. If the agency is a corporation the copy shall be delivered as provided in paragraph (3) of this subdivision of this rule.

(6) Upon a state or municipal corporation or other governmental organization thereof subject to suit, by delivering a copy of the summons and of the complaint to the chief executive officer thereof or by serving the summons and complaint in the manner prescribed by the law of that state for the service of summons or other like process upon any such defendant.

(7) Upon a defendant of any class referred to in paragraph (1) or (3) of this subdivision of this rule, it is also sufficient if the summons and complaint are served in the manner prescribed by any statute of the United States or in the manner prescribed by the law of the state in which the district court is held for the service of summons or other like process upon any such defendant in an action brought in the courts of general jurisdiction of that state.

(e) Same: Service Upon Party Not Inhabitant of or Found Within State. Whenever a statute of the United States or an order of court thereunder provides for service of a summons, or of a notice, or of an order in lieu of summons upon a *party* not an inhabitant of or found within the state in which the district court is held, service may be made under the circumstances and in the manner prescribed by the statute or order, or, if there is no provision

therein prescribing the manner of service, in a manner stated in this rule. Whenever a statute or rule of court of the state in which the district court is held provides (1) for service of a summons, or of a notice, or of an order in lieu of summons upon a *party* not an inhabitant of or found within the state, or (2) for service upon or notice to him to appear and respond or defend in an action by reason of the attachment or garnishment or similar seizure of his property located within the state, service may in either case be made under the circumstances and in the manner prescribed in the statute or rule.

(f) Territorial Limits of Effective Service. All process other than a subpoena may be served anywhere within the territorial limits of the state in which the district court is held, and, when authorized by a statute of the United States or by these rules, beyond the territorial limits of that state. In addition, persons who are brought in as parties pursuant to Rule 14, or as additional parties to a pending action or a counterclaim or cross-claim therein pursuant to Rule 19, may be served in the manner stated in paragraphs (1)-(6) of subdivision (d) of this rule at all places outside the state but within the United States that are not more than 100 miles from the place in which the action is commenced, or to which it is assigned or transferred for trial; and persons required to respond to an order of commitment for civil contempt may be served at the same places. A subpoena may be served within the territorial limits provided in Rule 45.

(g) Return. The person serving the process shall make proof of service thereof to the court promptly and in any event within the time during which the person served must respond to the process. If service is made by a person other than a United States marshal or his deputy, he shall

make affidavit thereof. Failure to make proof of service does not affect the validity of the service.

(h) Amendment. At any time in its discretion and upon such terms as it deems just, the court may allow any process or proof of service thereof to be amended, unless it clearly appears that material prejudice would result to the substantial rights of the party against whom the process issued.

(i) Alternative Provisions For Service In A Foreign Country.

(1) Manner. When the federal or state law referred to in subdivision (e) of this rule authorizes service upon a *party* not an inhabitant of or found within the state in which the district court is held, and service is to be effected upon the party in a foreign country, it is also sufficient if service of the summons and complaint is made: (A) in the manner prescribed by the law of the foreign country for service in that country in an action in any of its courts of general jurisdiction; or (B) as directed by the foreign authority in response to a letter rogatory, when service in either case is reasonably calculated to give actual notice; or (C) upon an individual, by delivery to him personally, and upon a corporation or partnership or association, by delivery to an officer, a managing or general agent; or (D) by any form of mail, requiring a signed receipt, to be addressed and dispatched by the clerk of the court to the party to be served; or (E) as directed by order of the court. Service under (C) or (E) above may be made by any person who is not a party and is not less than 18

years of age or who is designated by order of the district court or by the foreign court. On request, the clerk shall deliver the summons to the plaintiff for transmission to the person or the foreign court or officer who will make the service.

(2) Return. Proof of service may be made as prescribed by subdivision (g) of this rule, or by the law of the foreign country, or by order of the court. When service is made pursuant to subparagraph (1)(D) of this subdivision, proof of service shall include a receipt signed by the addressee or other evidence of delivery to the addressee satisfactory to the court.

Rule 13, FRCP

Rule 13. Counterclaim and Cross-Claim.

(a) Compulsory Counterclaims. A pleading shall state as a counterclaim any claim which at the time of serving the pleading the pleader has against any opposing party, if it arises out of the transaction or occurrence that is the subject matter of the opposing party's claim and does not require for its adjudication the presence of third parties of whom the court cannot acquire jurisdiction. But the pleader need not state the claim if (1) at the time the action was commenced the claim was the subject of another pending action, or (2) the opposing party brought suit upon his claim by attachment or other process by which the court did not acquire jurisdiction to render a personal judgment on that claim, and the pleader is not stating any counterclaim under this Rule 13.

(b) Permissive Counterclaims. A pleading may state as a counterclaim any claim against an opposing party not arising out of the transaction or occurrence that is the subject matter of the opposing party's claim.

(c) Counterclaim Exceeding Opposing Claim. A counterclaim may or may not diminish or defeat the recovery sought by the opposing party. It may claim relief exceeding in amount or different in kind from that sought in the pleading of the opposing party.

(d) Counterclaim Against The United States. These rules shall not be construed to enlarge beyond the limits now fixed by law the right to assert counterclaims or to claim credits against the United States or an officer or agency thereof.

(e) Counterclaim Maturing or Acquired After Pleading. A claim which either matured or was acquired by the pleader after serving his pleading may, with the permission of the court, be presented as a counterclaim by supplemental pleading.

(f) Omitted Counterclaim. When a pleader fails to set up a counterclaim through oversight, inadvertence, or excusable neglect, or when justice requires, he may by leave of court set up the counterclaim by amendment.

(g) Cross-Claim Against Co-Party. A pleading may state as a cross-claim any claim by one party against a co-party arising out of the transaction or occurrence that is the subject matter either of the original action or of a counterclaim therein or relating to any property that is the subject matter of the original action. Such cross-claim may include a claim that the party against whom it is asserted is or may be liable to the cross-claimant for all or part of a claim asserted in the action against the cross-claimant.

(h) Joinder of Additional Parties. Persons other than those made parties to the original action may be made parties to a counterclaim or cross-claim in accordance with the provisions of Rules 19 and 20.

(i) Separate Trials; Separate Judgments. If the court orders separate trials as provided in Rule 42(b), judgment on a counterclaim or cross-claim may be rendered in accordance with the terms of Rule 54(b) when the court has jurisdiction so to do, even if the claims of the opposing party have been dismissed or otherwise disposed of.

Rule 19, FRCP

Rule 19. Joinder of Persons Needed for Just Adjudication.

(a) Persons To Be Joined If Feasible. A person who is subject to service of process and whose joinder will not deprive the court of jurisdiction over the subject matter of the action shall be joined as a party in the action if (1) in his absence complete relief cannot be accorded among those already parties, or (2) he claims an interest relating to the subject of the action and is so situated that the disposition of the action in his absence may (i) as a practical matter impair or impede his ability to protect that interest or (ii) leave any of the persons already parties subject to a substantial risk of incurring double, multiple, or otherwise inconsistent obligations by reason of his claimed interest. If he has not been so joined, the court shall order that he be made a party. If he should join as a plaintiff but refuses to do so, he may be made a defendant, or, in a proper case, an involuntary plaintiff. If the joined party objects to venue and his joinder would render the venue of the action improper, he shall be dismissed from the action.

(b) Determination by Court Whenever Joinder Not Feasible. If a person as described in subdivision (a)(1)-(2) hereof cannot be made a party, the court shall determine whether in equity and good conscience the action should proceed among the parties before it, or should be dismissed, the absent person being thus regarded as indispensable. The factors to be considered by the court include: first, to what extent a judgment rendered in the person's absence might be prejudicial to him or those already parties; second, the extent to which, by protective provisions in the judgment, by the shaping of relief, or other measures, the prejudice can be lessened or avoided; third, whether a judgment rendered in the person's absence will be adequate; fourth, whether the plaintiff will have an adequate remedy if the action is dismissed for nonjoinder.

(c) Pleading Reasons For Nonjoinder. A pleading asserting a claim for relief shall state the names, if known to the pleader, of any persons as described in subdivision (a)(1)-(2) hereof who are not joined, and the reasons why they are not joined.

(d) Exception of Class Actions. This rule is subject to the provisions of Rule 23.

BASIS OF JURISDICTION BELOW

Original jurisdiction was based upon D.C. Code Ann. §§11-521, 11-961 (1967). The effect of these provisions was to vest civil jurisdiction in the United States District Court for the District of Columbia for all cases wherein the amount in controversy was greater than $10,000.00. This jurisdictional anomaly no longer exists.

STATEMENT OF FACTS

During the summer of 1968, a local group of entrepreneurs seized upon the idea of developing a corporation whose emphasis would be "black capitalism." Blacks were to be trained in the use of computers while the government, which had at that time come to favor such ventures as a matter of policy, was to provide the necessary contracts for computer or management services. By securing such contracts and then making a public offer of what was then considered a "hot issue" the original investors hoped to make a substantial profit in capital gains. The original investors had paid a mere $.01 per share for the new company whereas they planned to get $4.00 per share for a new issue of 250,000 shares when they went public. The remainder of the original subscribers' investment was categorized as a loan guaranteeing them interest regardless of the profitability of the enterprise and giving them a priority claim against any assets of the company if the enterprise failed. Thus the originators of the scheme, realizing the high degree of risk involved in such a speculative venture, hedged against possible disaster by using a lopsided, undercapitalized corporate financial structure.

THE ORIGINS

The seed money for the proposed Urban, Research and Systems, Inc. (Urban) was raised through the efforts of at least four individuals: Harvey Rosenberg, a Silver Spring, Maryland lawyer, skilled in corporate law and an incorporating attorney on numerous occasions; Harry Niedermayer, a known promoter of business ventures and a partner in an insurance business in Silver Spring, Maryland; Herbert Mendelsohn, Niedermayer's partner in the insurance

business; and Larry Eichler, a New York City C.P.A. who solicited investors from among his clients and was successful in getting Messr. Simon, Zadek and Gershen to invest $5,020.84 each as well as investing himself. Niedermayer and Mendelsohn were the most successful in promoting the company, raising some $70,000 to $75,000 out of the $91,635.11 invested in Urban as of October 23, 1968.

The plan for financing the proposed company consisted of asking each investor to pay a nominal sum for their shares, a penny a share, while at the same time loaning the corporation a substantial amount for a period of five years at 6% interest. The number of shares an investor could buy was directly limited by, and proportionate to, the amount of money he was willing to loan. For example, those investors who loaned the company $2,500.-00 were allowed to purchase 1,042 shares for $10.42. *See* testimony of Carl Golden, and Meyer Wertleib. An investor willing to loan twice as much was entitled to twice as many shares. Thus, Leon D. Laffal, one of the named plaintiffs, loaned the company $5,000.00 and thereby received 2,084 shares for $20.84.

The loans were later convertible to stock at $4.00 per share but only if the company went public. Stock which the investors purchased at a penny a share was to be valued at $4.00 a share when the company went public, thus enabling all the original investors to earn a substantial capital gain. At the same time their loans would be paying 6% interest regardless of whether the company was turning a profit. In fact, the company did make four quarterly interest payments. The loans represented two additional advantages to the investors: first, if after going public the company prospered the loan-holders would be able to convert at the original asking price of $4.00 thus

realizing another capital gain; second, if after going public the company floundered the loan-holder's claims against the company assets would have priority over the claims of mere shareholders.

Niedermayer, Mendelsohn, Rosenberg and Simon Ratner discussed plans for raising these funds over lunch on a number of occasions. Rosenberg, being the only attorney in the group, handled any legal questions that came up and drew up the corporate charter. In return for Rosenberg's services as promoter he was to receive about one percent of the Urban stock. Niedermayer was then to take 50% of whatever Rosenberg received. Neither Niedermayer nor Rosenberg directly invested in Urban but Niedermayer and Mendelsohn took over the investment of Mendelsohn's cousin Max by reimbursing him $5,020.84.

Urban Systems Research, Inc. (Urban) was incorporated on September 27, 1968 with the purpose of developing and selling "computer programs, software and data processing services." See the third article of Urban's Articles of Incorporation, Exhibit No. 10. The sixth article of Urban's Articles of Incorporation names eight initial directors "who shall act until the first annual meeting or until their successors are duly chosen and qualify." Among the original directors were Harry Niedermayer, Simon Ratner, Dr. William L. Staton and Theodore S. Garfinkle. Later, in October 28, 1968, Harry Niedermayer was designated Urban's president, Dr. Staton, its vice-president, and Harvey Rosenberg, its secretary.

Unfortunately Urban never really got off the ground. Almost immediately after incorporation a dispute arose concerning who was to control the corporation. In addition, there was some dissatisfaction with the name "Urban" and the desire was to use a different name which

connoted the company's emphasis on black capitalism. Rosenberg and Niedermayer, in order to protect the investors' interest in the control issue, decided to form a new corporation whereby a name change could be accomplished but most importantly a different slate of officers could be adopted. In order to facilitate this transition and at the same time hold the funds invested in Urban, Niedermayer, as president of Urban, and Rosenberg, as its secretary, opened a corporate account in Urban's name with a deposit of $62,823.01.

The new company to which the assets of Urban would be transferred was Ebony Systems and Management Company, Inc. (Ebony). Ebony was incorporated October 25, 1968 adopting substantially identical Articles of Incorporation as Urban but listing six directors: Harry Niedermayer, Simon Ratner, William L. Staton, Lawrence A. Purnell, Emily T. Jackson and Rubin Perry. The carryovers from Urban's Board of Directors, Niedermayer, Ratner and Staton now had 50% control of the new company whereas in Urban they had only three-eighths control. This shift in control meant that investors would be represented on an equal basis with the operators of the company. Thus the basic purpose of shifting corporations had been accomplished.

Ebony employed Lawrence Purnell, a civil engineer who was then associated with the Godard Space Flight Center in Greenbelt, Maryland, as its president. Purnell conceived the name "Ebony" and in addition changed the emphasis of the company from predominantly computer operations to systems and management. Purnell was to hire a vice-president and other officers to get the company started. Niedermayer and Rosenberg, as officers of Urban, delivered two $1,500.00 checks drawn on Urban's account to

to Purnell to fund this recruitment of personnel. Purnell enlisted the aid of Rubin Perry, an I.B.M. employee whom Purnell knew in college, as vice-president, and Emily Jackson as secretary-treasurer. Both agreed to work without salary. In addition, Purnell set up an office and hired a personal secretary, Yvonne Wood.

During the period of Ebony's operation, from November, 1968, through January, 1970, Purnell himself spent over thirty hours a week doing research on the various Manpower Assistance Programs offered through the government, meeting with people familiar with these programs and traveling on behalf of the corporation. During this period of operation of Ebony, Purnell, working in collaboration with Ed Dixon, who assumed the role of vice-president on Rubin Perry's resignation in April, 1969, produced five proposals for the company, two Manpower Assistance proposals, M.A. 4 and M.A. 5, a proposal to Catholic Charities, one to the Winston Burnett Company and the LAPCO project, a proposed subsidiary of Ebony that was to buy properties, rehabilitate them and then resell them at a profit. Unfortunately none of the proposals resulted in contracts and the Lapco project never got off the ground.

THE AARDVARK AFFAIR

Harry Niedermayer, in addition to being a principal promoter of Urban, and director of Ebony, its successor, also raised some $50,000.00 for Aardvark Audio Productions, Inc. (Aardvark), a music recording and reproduction business, incorporated October 21, 1968. Harvey Rosenberg was Aardvark's attorney and had prepared its Articles of Incorporation. Both were to be compensated in Aardvark stock under an arrangement similar to the one they

had with Urban. Some of the investors in Ebony had also invested in Aardvark including Simon Ratner for about $7,500, Herbert Mendelsohn's brother Max, and Dr. William Staton.

Aardvark was in need of some cash to purchase some equipment for their recording studio. The company had not at that time received its capital contributions, so Urban, under the signatures of Niedermayer, its president, and Rosenberg, as secretary, loaned $20,000.00 to Aardvark in return for promissory notes to be secured by a chattel mortgage on the purchased equipment and 25,000 shares of Aardvark. Rosenberg did not secure the promissory notes immediately because Aardvark was to pay the loan off as soon as it received its capital contributions which was expected within 30 to 60 days. These funds were never received so that Rosenberg eventually obtained the promissory notes on October 13, 1969. The notes totaled $31,000 which included an additional bonus to Ebony as well as covering other funds advanced by Ebony on behalf of Aardvark totaling $2,597.60. The chattel mortgage was never prepared but the 25,000 shares of Aardvark were issued to Ebony. These interests and claims against Aardvark become worthless as its funds were completely depleted.

THE COLLAPSE OF EBONY

Ebony's own financial situation worsened. The losses sustained by Ebony by the failure of Aardvark were compounded by the demands of Larry Eichler, one of Ebony's original promotors, that the funds invested by his clients be returned. In July, 1969, Eichler wrote to Rosenberg threatening suit unless the money was returned. Purnell, president of Ebony, flew to New York to discuss their

demands with Eichler. Rosenberg, Ed Dixon, vice-president of Ebony, and Mr. Gershen, one of the New York investors, also attended the meeting. Rosenberg then advised that the funds be returned on the grounds that one interest payment was 45 days late and that under the terms of the note the principal could be called. Thereupon, on July 22, 1969, two checks were drawn by Purnell in the amount of $5,020.84 each, one to Daniel Simon and one to Arthur Zadek. Mr. Gershen's check was not sent until October 3, 1969. By this time others began to concern themselves over Ebony's future.

THE SHAREHOLDERS' COMMITTEE

Leon D. Laffal, plaintiff-appellee in this cause and owner of 2,084 shares of Ebony as well as a $5,000 note became concerned over the lack of information concerning Ebony's affairs and wrote Harvey Rosenberg March of 1969 for a progress report. Receiving no response (there was no evidence that Rosenberg had ever received the letter) Laffal stopped by to meet with Rosenberg in June and was assured that everything was fine. After addressing a second letter to Rosenberg on December 3, calling for a conference of interested parties, Laffal received an announcement, dated December 6, 1969, calling for a stockholders' meeting for December 18th.

In the meantime the officers and directors of Ebony conducted their first two Board of Directors meetings. Lawrence Purnell, Ebony's president, was concerned about Ebony's condition and decided to call a meeting of the Board of Directors to explain what had transpired. The first meeting was held on October 6, 1969, and the Board proceeded to "legally and officially install him (Purnell) as president and Chairman of the Board of Directors "and

also" agreed that all actions by Mr. Purnell, and in particular those questionable items on advice of counsel, had the *full approval of the Board.*" The Board decided to question Harvey Rosenberg on all of Ebony's financial transactions and this was accomplished at a second meeting of the Board of Directors held on October 13, 1969. Although ostensibly not completely satisfied with Rosenberg's responses, the Board took no further action.

The first Stockholders Meeting proceeded as scheduled on December 18, 1969, attended by 17 of Ebony's stockholders. The shareholders, unsatisfied by the explanations of Ebony's financial condition, decided to form a committee, chaired by Leon Laffal, to look into the matter. Laffal, as chairman of the Committee, wrote to Rosenberg demanding further explanation of his actions, return of some $40,000.00 and his attendance at a second stockholders' meeting to be held January 5, 1970. A second meeting was finally held on January 12 but Mr. Rosenberg was unable to attend. Lawrence Purnell offered to resign but instead was given a vote of confidence and unanimously voted executive authority along with Leon Laffal. Funds were appropriated for a lawyer to look into possible legal action against the Board of Directors and Attorney Rosenberg. The affairs of Ebony were thereupon terminated and suit was filed on behalf of the shareholders in February, 1970.

NO EVIDENCE OF MALICE

There is no evidence of malice on the part of defendant Rosenberg. In fact, the only testimony was that of co-defendant Lawrence A. Purnell when examined by his own attorney negative malice on Rosenberg's part as follows:

> THE WITNESS: Well, I have a high personal regard for Mr. Rosenberg and during that time we became very close friends. Mr. Rosenberg never did anything to harm me or anyone else, I don't think . . . .

Actions, words, orders and adverse rulings both prior to trial and at trial as more fully brought forth in part IV of the argument herein shows that the trial judge prejudiced against the defendant Rosenberg which culminated in the Court's finding of punitive damages against defendant Rosenberg.

SUMMARY OF ARGUMENT

The appellant Rosenberg contends that the lower court lacked jurisdiction to entertain the case at bar because the shareholders failed to make the requisite demand on the corporation's shareholders and that this failure was not justified under the circumstances of the case at bar. The appellant also contends that the Trial Court's award of punitive damages was contrary to Maryland law. The law in Maryland requires a showing of actual malice before an award of punitive damages can be made. Neither the lower court's findings nor the evidence supports a conclusion of actual malice. In addition the appellant contends that in awarding compensatory damages the lower court erroneously included the sum of $15,062.52, $15,000.00 of which represented the repayment of past due notes legitimately owned by the corporation. The satisfaction of outstanding and presently due liabilities cannot be said to legally injure the corporation.

The trial judge through his acts, words, orders and adverse rulings prejudiced the case against defendant Rosenberg, and was otherwise prejudiced against defendant Rosenberg culminated in the Court's award of punitive damages against defendant Rosenberg.

I. SERVICE OF PROCESS HEREIN WAS NOT PROPER ON PETITIONER ROSENBERG. HENCE THE TRIAL COURT LACKED PERSONAL JURISDICTION OVER HIM.

Petitioner Rosenberg was named as a defendant on the original complaint herein, but plaintiff's efforts to effect service of process on him were ineffectual. Hence Mr. Rosenberg was never served as an original defendant and was not before the court on that basis. His presence before the trial court arose as a result of certain cross-claims filed by the original defendants herein. The cross-claims were filed against Mr. Rosenberg only and no cross-claims were filed relating to claims of the original defendants against each other. The cross-claiming parties sought to join Mr. Rosenberg as an additional party on the cross-claim under Rule 13(h) which provides for such joinder where suited under the provisions of Rule 19. The trial court granted this motion and permitted service on Mr. Rosenberg under Rule 4(f), despite objection by Mr. Rosenberg.

Rule 13(h) permits an additional party to be joined on a cross-claim. Rule 13(g). A valid joinder of additional parties on a cross-claim, therefore, may exist only when the cross-claim was stated against one already a co-party and the additional party is brought in to afford complete relief and avoid circuity of action. The case law, although sparse, supports this view. *Sternaman v. Macloskie*, 37

F.R.D. 316 (E.D.S.C. 1965) (one cannot assert cross-claim solely against a complete stranger to the action); *see United States v. Techno Fund, Inc.*, 270 F. Supp. 83 (S. D. Ohio, 1967) (Rule 13(h) will not permit joinder of new party on counter-claim where such counterclaim was directed solely at new party and not against any original plaintiff); *United States v. Zashin*, 160 F. Supp. 843 (E.D.N.Y. 1958) (counterclaim directed solely against additional defendant dismissed). *See also Grubbs v. General Electric Credit Corp.*, 405 U.S. 699, 705 & n. 2 (1972) (dicta) (suggests that cross-claim must be against co-party "already in the lawsuit").

Mr. Rosenberg, of course, was never served as an original defendant and was thus not a party to the suit as required. Hence the guidelines of Rule 19 did not apply and service was not subject to the "100-mile rule" of Rule 4(f). Despite his objection, however, Mr. Rosenberg was kept in the case by the trial judge. This was clearly in contravention of the Federal Rules of Civil Procedure.

II. THE TRIAL JUDGE WAS SO BIASED AND PREJUDICED HEREIN THAT MR. ROSENBERG WAS DEPRIVED OF HIS FIFTH AMENDMENT RIGHT TO FAIR TRIAL AND DUE PROCESS.

Litigants are entitled to a trial before a tribunal free from bias and prejudice. *Baker v. Simmons Co.*, 342 F. 2d 991 (1st Cir. 1965). A trial judge must not only be impartial, he must avoid all appearance of not being so. *See Commonwealth Coatings Corp. v. Continental Cas. Co.*, 393 U.S. 145 (1968); *Texaco Inc. v. Chandler*, 354 F.2d 655 (1965). Clearly a trial before a biased judge is not due process. *Tumey v. Ohio*, 273 U.S. 510 (1927); *National Labor Relations Bd. v. Ford Motor Co.*, 114 F.2d

905 (6th Cir. 1940). Such a deprivation of rights is shown by the making of a judgment before hearing all of the evidence. *See Rosenberg v. Baum*, 153 F.2d 10 (10th Cir. 1946). A cursory review of the statements and actions of the trial judge herein shows that he achieved neither the appearance nor the reality of impartiality and that his bias and prejudice against petitioner deprived Mr. Rosenberg of due process in that he could not – and did not – receive a fair trial.

First a hearing was held before the court on August 11, 1970 on defendant Rosenberg's Motion to Quash Service of Cross claim. Prior to the hearing, the original Complaint had been served on defendant Rosenberg while he was in Holy Cross Hospital located in Silver Spring, Maryland; such service of process was quashed by Judge Curran. No other service of original process was attempted. Then cross claiming defendants (all other defendants besides defendant Rosenberg) served a cross claim on defendant Rosenberg's wife at his home address in Silver Spring, Maryland supposedly pursuant to Rule 4(f) of the Federal Rules of Civil Procedure. The court held that defendant Rosenberg was properly served with the cross claim under Rule 19(a) even though at that point Rosenberg wasn't a defendant. How can you serve a cross claim on a person who is not a defendant? The Court went on to order Rosenberg also to answer the original Complaint stating as follows on page 4 of Transcript:

> And while I am on the subject, I think it would be a good idea for Mr. Rosenberg, a member of the bar of the District of Columbia, who maintains an office in the District of Columbia, to make himself available in the District of Columbia for the service of process.

> I think that this kind of conduct by a lawyer who is the subject of some very serious allegations is not the type of thing that we ought to permit to go unchallenged. And I think you would do well to advise him to submit to service of process.

and again stating on pages 4 and 5:

> Because he will be caught up with sooner or later, and he had better do it sooner than later. He is prejudicing himself by this kind of conduct, I can tell you.

and again in the same hearing when questioned by Mr. Forester concerning the propriety of turning the matter (*i.e.*, the unproven allegations against defendant Rosenberg) over to the Committee on Admissions and Grievances the Court replied as follows at page 6:

> Well, my off-the-cuff reaction, Mr. Forester is that you pursued it just right. I don't think that you should use the Grievance Committee machinery as a lever on this defendant.
>
> The allegations are, after all, unproven. They are really matters which the Court is better able to determine than the Grievance Committee. *But if you have any further difficulty in making service of process upon Mr. Rosenberg, I wish you would let me know.* [Emphasis ours].

At this point counsel for defendant Rosenberg began to question the trial judge's impartiality. It is submitted that the judge envisoned a corporation short approximately $91,000.00 and an attorney allegedly guilty and that he has never deviated from the belief that the attorney is guilty.

Second, a hearing was held on March 11, 1971, again before the Court, on the co-defendants' (all defendants but Rosenberg) second Motion to Strike Answer to Cross-claim which was granted, but which later was reversed on defendant Rosenberg's Motion for Re-hearing on Motion to Strike Answer to Cross Claim. At the hearing the Judge stated as follows at page 10 of the Transcript:

> Mr. Donovan, Mr. Rosenberg is playing games with this Court. He has been playing games with the parties. While if he was a layman, that type of thing might not call for such scrutiny. It seems to me that he is getting awfully close to the line of maybe a reference to the Grievance Committee.
>
> I am going to grant the Motion to Strike his amended answer to the cross claim. I note that he was given thirty days to respond with amended answer. And, he still hasn't met the objections that were noted before. In addition to that, he had to be ordered to answer certain Interrogatories prior to that time. There was a lot back and forth about service on him.
>
> Certainly any lawyer licensed to practice in the District of Columbia, and having an office in the District of Columbia should be amenable to service process [sic] at his office. He ducked service repeatedly, and was finally nailed, and he is now before this Court.
>
> I don't have any sympathy for him. I think his conduct is outrageous, and I wish you would tell him so.

and again the Court said in response to Mr. Greenberg (counsel for all defendants but Rosenberg) at page 11:

> "I said I would grant your Motion to Strike Mr. Rosenberg's Answer to the Cross Claim. And, as a preliminary to that, I pointed out that he had been given an opportunity to amend a previous answer to a Cross claim. He had to be ordered to answer Interrogatories. I also said I thought his conduct was outrageous."

At that point the trial court ordered default judgment on the other defendants' cross claim against defendant Rosenberg which was reversed only when pinned to the wall by defendant Rosenberg's attorneys when they filed their Motion for Rehearing as aforesaid as well as filed a letter dated March 15, 1971 indicating that the liability of the cross claim defendant Rosenberg should be considered at the trial because of the entwinement of the claims of the original Complaint and the Cross claim and the alleged joint liability of all defendants in the original claim. Such letter further pointed out that a default judgment could not be entered for the full amounts of the compensatory damages sought in Count 1 of the Cross claim without an inquisition as to the amount of damages pursuant to Rule 55(b)(2) of the Federal Rules of Civil Procedure.

The Court's impression of Mr. Rosenberg at this hearing is not bourne out by the facts in that Mr. Rosenberg had not ducked service – the record shows that original service on him was quashed by Judge Curran because it was made at Holy Cross Hospital while Mr. Rosenberg was recovering from a heart attack. The trial judge himself sustained service of the cross claim across state lines, and ordered defendant Rosenberg to submit to service of the original

Complaint as aforesaid. The judge further reversed his decision on striking the amended answer to the cross claim at a later time. Moreover, defendant Rosenberg had previously been ordered by the judge on November 16, 1970 to pay $120.00 as attorney's fees for his alleged failure to completely answer a total of 41 questions out of 182 questions contained in 94 Interrogatories. Rosenberg's answers at the very least were a substantial compliance, and the Court was on thin ice in awarding such attorney's fees. Thus, the die was cast by the statements of the trial judge at the August 11, 1970 and March 11, 1971 hearings.

Third, defendant Rosenberg moved long before trial and pre-trial for leave to bring in Simon Ratner as a third party defendant. Defendant's Motion was denied by an Order signed by the trial court on June 4, 1971. The trial of the case took place on May 8th and 9th, 1972 – almost a year later. It was important to bring in Simon Ratner because he was a director of Ebony Systems and Management Co., Inc. (May 8, 1972, T. 41-47), – because he was the sole person on whom the plaintiff Leon D. Laffal relied upon in the purchase of his stock and in all matters concerning the corporation prior to the spring of 1969 (May 8, 1972, T. 41, 44), Simon Ratner was involved in Aardvark Audio Productions, Inc. (May 8, 1972, R. 48), and was a personal friend of the plaintiff Laffal (May 8, 1972, T. 42). It is defendant Rosenberg's contention that his case would have been settled if the Court had allowed Simon Ratner to be brought in as a third party defendant. Even if that contention is not correct Ratner was a necessary party to the suit. *Rosalis v. Universal Distributors, Inc.* (D.C. Conn., 1957), 21 F.R.D. 169, holds that an order granting motion by defendant for leave to implead insurer as third party defendant should not be vacated on ground that motion was not timely,

though motion was made nearly 27 months after answer and more than 18 months after pre-trial order indicating that case was ready for trial to jury, in absence of showing that delay was prejudicial to third party defendant. It is submitted that following *Rosalis, ibid,* defendant Rosenberg was clearly entitled to implead Simon Ratner as a third party defendant. The judge's failure to allow such action again shows the extent of his prejudgment of defendant Rosenberg.

Fourth, defendant Rosenberg requested a jury trial on both the original claim and the cross-claims that he filed and that were filed against him. On the original claim, the original answer filed September 25, 1970 did not make such a demand neither did the amended answer filed January 8, 1971 but the amended answer including a cross-claim filed on March 15, 1971 did contain such a demand. On the cross claims of all defendants except defendant Purnell, no jury demand was made by defendant Rosenberg because the cross claimants themselves demanded a jury, but on the cross claim of defendant Purnell a jury demand was made by cross claim defendant Rosenberg (see answer to cross claim of defendant Purnell filed during March, 1971). On defendant Harvey Rosenberg's cross-claims against Purnell (see answer to cross-claim of defendant Purnell filed during March, 1971 which includes a cross claim against all defendants) a jury trial was demanded. The plaintiffs on the 5th day of October, 1971 made a Motion to strike the jury demands which was granted by the Court at one of the pre-trial hearings. That there is a right to a trial by jury in a stockholder's derivative action that is in the nature of an accounting action, but where a money judgment is sought. As in the instant case, see *Ross v. Bernhard,* 296 U.S. 531, 24

L.Ed.2d 729 (1970), reversing the second Circuit Court of Appeals and affirming the judgment of the lower court in *Ross v. Bernhard*, 275 F. Supp. 569 (S.D.N.Y., 1967). The *Ross* case resolved the conflict between the circuits in favor of the view of the Ninth Circuit Court of Appeals stated in *De Pinto v. Provident Security Life Ins. Co.*, 323 F.2d 826 (9th Cir., 1963), which held that although the aid of equity is needed in order to establish the stockholder's right to sue on behalf of the corporation, the claim is that of the corporation and the right to a jury trial is to be judged as though the corporation were suing. The District Court in *Ross, supra*, which decision was affirmed by the United States Supreme Court stated in 275 F. Supp. 570-71 as follows:

> The fact that plaintiffs seek an accounting, a word which smacks of equity, is not determinative. *Dairy Queen, Inc. v. Wood*, 369 U.S. 469, 82 S.Ct. 894, 8 L.Ed.2d 44 (1962).
>
> Plaintiffs are seeking a money judgment. They ask that defendants "pay" to the corporation defendants' gains and the corporation's loss. The issues are not so complicated as to make it impracticable for a jury to ascertain the amount, if any, to which plaintiffs may be entitled.
>
> It is true that the complaint employs equitable language in alleging that defendant directors have abused their trust and have disregarded their fiduciary duties. But the alleged facts which underlie these conclusions are simply that defendants have caused the corporation to pay out money which the corporation should not have paid, and that in consequence, the

> corporation is entitled to judgment for those moneys. This diversion of funds is alleged to be a conversion by defendants of the corporate assets. Whatever the law may formerly have been, I am persuaded that recent decisions of the Supreme Court, which have gone far in protecting the right to a jury trial under the Seventh Amendment, require the conclusion that this complaint states on behalf of the corporation a claim which is fundamentally legal rather than equitable. *Dairy Queen, Inc. v. Wood, supra; Beacon Theatres, Inc. v. Westover,* 359 U.S. 500, 79 S. Ct. 948, 3 L.Ed.2d 988 (1959); see also *DePinto v. Provident Security Life Insurance Company, supra.*

The fact that it was the plaintiffs seeking a jury trial in *Ross* is not determinative, because a defendant can demand a jury trial in a case seeking a money judgment as well as the plaintiff. By ruling that defendant Rosenberg was not entitled to a jury trial and by having strictly a court trial, the trial judge spun his net to enclose Rosenberg fully and to leave him strictly at the mercy of his prejudgment.

Defendant Rosenberg made a motion for change of venue which was denied even though most of the parties and witnesses were from Maryland, all actions occurred in Maryland, Maryland corporations were involved and Maryland law applies.

Defendant Rosenberg prior to trial, however, did not submit an affidavit pursuant to Title 28 U.S.C. Section 114 entitled "Bias or prejudice of judge" following the reasoning of the line of cases which have held that personal bias of the judge must be shown by conduct and

acts which are outside of rulings made in the case at bar, *e.g., In Ex parte American Steel Barrel Co.*, 230 U.S. 35, 43, 33 S.Ct. 1007, 1010, 57 L.Ed. 1379 where it was said:

> The basis of the disqualification is that 'personal bias or prejudice' exists, by reason of which the judge is unable to impartially exercise his functions in the particular case. It is a provision obviously not applicable save in those rare instances in which the affiant is able to state facts which tend to show not merely adverse rulings already made, which may be right or wrong, but facts and reasons which tend to show personal bias or prejudice. *It was never intended to enable a discontented litigant to oust a judge because of adverse rulings made, for such rulings are reviewable otherwise, but to prevent his future action in the pending cause.* [Emphasis supplied].

This language is quoted with approval by Judge Soper in *Morse v. Lewis*, 54 F.2d 1027 (4th Cir., 1932). However, this Court can determine the issue of the trial Court's impartiality based upon the trial Court's spoken words, conduct and adverse rulings.

That the trial Court had further prejudged defendant Rosenberg is shown by the fact that it admitted testimony based upon Exhibit No. 58 for impeachment purposes over timely objection (May 9, 1972, T. 87-93) even though the pre-trial order was based on instructions from the judge that there be no surprise in the trial and that none of the defense lawyers had seen the document prior to that date, and that they had been assured prior to trial by plaintiffs' attorney that all documents would be turned over to them prior to trial. The trial court's *Policy Underlying Pre-trial Procedure* states on page 2 as follows:

> You are reminded that ". . . [s]urprise, both as a weapon of attack and defense is not to be tolerated under the . . . federal procedure." [citation omitted].

and again on page 3:

> The pre-trial conference is not a mere formality. It is a vital stage in your preparation for trial. You should therefore prepare thoroughly for the conference with the end of converting a lawsuit from a game of maneuver and surprise into a rational, orderly search for truth and right.

That this policy no longer was important when defendant Rosenberg tried to invoke it, see once again the May 9, 1972 transcript at pages 87-93. Defendant Rosenberg was entitled to have the trial proceed according to the pre-trial order (supposedly based upon a policy of no surprise).

The trial judge further dismissed two of the directors (defendants Jackson and Staton) from the case at the end of the case (May 9, 1972, Tr. 186-189) holding in effect that they were simply paper directors and had never acted as directors even though they knew that they were directors, and had the obligation in Maryland of serving until the first annual meeting (which can be as long as one year after the Articles of Incorporation are filed) or until their successors are duly chosen and qualified. Article 23, Section 52(b) of the Annotated Code of Maryland. Further, management of a corporation in Maryland is the responsibility of the Board of Directors, Article 23, Section 52-(a) of the Annotated Code of Maryland. Knowledge of misdeeds must be imputed to the corporation (through its directors) where corporate control has been abdicated by those charged with exercising such control and all corporate

power is exercised by a few who perform misdeeds, *Phoenix Savings and Loan, Inc. v. Aetna Casualty and Surety Company*, 427 F.2d 862 (4th Cir., 1970), applying Maryland law.

The trial judge further showed his lack of impartiality when the following discussion took place between the Court and defense counsel for defendant Rosenberg (May 9, 1972, T. 181-182):

> MR. DONAHUE: Well I think everyone has rested and on behalf of the defendant Rosenberg we would merely like to renew our motion for dismissal or for judgment and renew our prior arguments again earlier advanced by Mr. Jorgensen this afternoon. You made a reservation, I believe, on punitive damages [defendant Rosenberg was the only target of a punitive damage claim in the Complaint] – I am not sure – and I don't know if you want any further points on that particular aspect.
>
> THE COURT: No, I have thought about it and I am going to leave punitive damages in the case, Mr. Donahue.

and at page 91 of the same transcript:

> THE COURT: . . . We will stand recessed until further call but I would emphasize again that it might be in everyone's best interest if you gentlemen got together.

The import of the above language needs no further argument.

III. THE TRIAL COURT ERRED IN FINDING THAT THE SHAREHOLDERS WERE JUSTIFIED IN FAILING TO MAKE A DEMAND ON EBONY'S DIRECTORS AND IN FAILING TO RULE ON THE NECESSITY FOR A DEMAND ON EBONY'S SHAREHOLDERS.

It is a well-settled general rule of Maryland corporate law that an action for damages for an injury to a corporation can only be brought in the name of the corporation itself, acting through its directors, and not by an individual stockholder. *See Indurated Concrete Corporation v. Abbott,* 195 Md. 496, 74 A.2d 17 (1950); *Waller v. Waller,* 187 Md. 185, 49 A.2d 449 (1946); 6 Maryland Law Encyclopedia, Corporations §151. The courts, however, recognize an exception to this general principle in the so-called shareholder derivative suit. *Waller v. Waller, supra; Pritchard v. Myers,* 174 Md. 66, 197 A. 620 (1938). This right of the shareholder is recognizable only in equity as an extraordinary means of relief when normal internal corporate channels are shown to be unavailing. Thus the right of any shareholder to bring a derivative action depends on his demonstrating an "earnest and unsuccessful effort to obtain remedial action by the Corporation itself, first by application to the directors and then by application to the body of the stockholders." *Eisler v. Eastern State Corporation,* 182 Md. 329, 333, 35 A.2d 118 (1944). This prerequisite arises from the traditional rule of equity that one invoking equitable relief must demonstrate that he has no adequate remedy at law. *Corbus v. Alaska Treadwell Gold Min. Co.,* 187 U.S. 455, 23 S.Ct. 157; 19 Am. Jur. 2d §528. This prerequisite is not absolute, however, and a demand need not be made "where the circumstances are such that an application would be futile." *Eisler v. Eastern State Corporation, supra* at 333.

Although not all jurisdictions require a demand on the shareholders as well as the directors, the law of Maryland clearly does require this additional step. *Parish v. Maryland and Virginia Milk Producers Ass'n*, 250 Md. 54,242 A.2d 512 (1968); *Eisler v. Eastern States Corporation, supra.* In addition, Rule 23.1 of the Federal Rules of Civil Procedure also calls for a demand on shareholders as well as the directors or the "reasons for not making the effort." Professor Moore explains the requirement in the following terms:

> The fact that a demand has been made upon the directors and they have refused to act, does not, however, ipso facto, relieve the plaintiff from seeking corporate redress from the shareholders. * * * When, however, state law does require an effort as a condition precedent to the maintenance of a derivative action the rule determines the necessity of pleading the effort as well as the particularity of the pleading. If the allegation is required, the fact that the shareholders live all over the United States and vote by proxy will not relieve plaintiff from making it. If the corporation has no directors, the plaintiff must call a shareholders' meeting and there seek action against the defendant before he will be permitted to institute suit.
>
> When a demand upon the shareholders is required by the substantive law, but such a demand like a similar demand upon directors, would be "an idle ceremony," the plaintiff may forego this condition precedent. What constitutes conditions wherein a demand upon the shareholders would be an idle ceremony is not certain. But if the directors implicated in the fraud, also

> hold a majority of the share, it is clear that the demand upon them, qua shareholders, may be dispensed with.

3B Moore's Federal Practice §23.1, 19 at 23.1-257 to 23.1-259. Thus, whether the issue of the requisite demand is governed by state law as substantive or by federal law as procedural, jurisdiction in the instant case was lacking because of the shareholders failure to explain those circumstances which justified not making a demand on the shareholders.

The parties to the instant case have never disputed the fact that the shareholders never made a demand on either the directors or the shareholders. The shareholders instead plead justification for the failure, because any demand would have been futile.

Paragraph 5 of the shareholders' complaint stated:

> 5. No demand has been made upon the corporation to institute this action on its own behalf because such demand would be futile inasmuch as it is dominated by the defendant Rosenberg, the principal wrongdoer. In addition, the individual defendants are designated directors of the corporation and would not institute suit against themselves.

The allegation does not satisfy the "particularity" requirement of Rule 23.1:

> The complaint shall also allege *with particularity* the efforts, if any, made by the plaintiff to obtain the action he desires from the directors or comparable authority and; if necessary, from the shareholders or members, and the reasons for his failure to obtain the action or for not making the effort.

Rule 23.1, Federal Rules of Civil Procedure. See also, 3B Moore's Federal Practice, paragraph 23.1s 19 at 23.1-251. Despite this lack of specificity, the Trial Court held that "the circumstances warranted their bringing suit without making what would have been a useless demand upon the *directors.*" However, no ruling was ever made on the concommitant requirement to make a similar demand on the shareholders of the corporation.

Moreover, even assuming that this additional ruling was implicit in the result, reached by the lower court, it would be clearly erroneous in the light of the evidence adduced at trial. Neither the Trial Court's Finding of Facts nor any other facts reasonably inferrable from the evidence presented indicates any reluctance on the part of the majority of the shareholders of Ebony to bring an action against the members of its Board of Directors. At the first stockholders meeting on December 18, 1969, 17 of the 20 investors in Ebony were apparently agreed on the need for legal action against the Board and Rosenberg. See Exhibit 22. The shareholders elected a committee to inquire into the circumstances of certain transactions by *unanimous vote.* See letter to Harvey Rosenberg from the Stockholders Committee dated 19, 1969, attached to Exhibit 22. "The stockholders unanimously agreed that the funds referred to in paragraphs 1a (the return of $15,000 to their investors) and b (the $25,000 in loans to Aardvark) above totalling approximately $40,000.00 should be restored by you to ES§M not later than December 26, 1969. In addition, we request your presence at a stockholders meeting to be held at the office of ES§M at 7:30 p.m." *Id.*

Why the shareholders did not continue to follow these normal channels of corporate redress is never explained. Although a second stockholders meeting was held on Jan-

uary 12, 1970, with a "discussion of possible legal action against Board of Directors and Harvey Rosenberg" the shareholders somehow decided on a derivative suit even though they represented a large majority of Ebony's stockholders and the fact that Ebony's Precedent, Lawrence Purnell, who was in effecture control of all the company's assets, was more than willing to cooperate and assert in the prosecution of a suit. *See* Exhibit 25.

In finding the shareholders' failure to make a demand on the directors justified, the lower court relies on *Parish v. Maryland & Virginia Milk Producers Ass'n*, 250 Md. 24, 242 A.2d 512 (1968). A close examination of the facts and holding of that case demonstrates that an opposite conclusion should have been reached. In *Parish*, members of a milk producers farm cooperative brought a derivative action against the cooperative, its directors, former directors and certain employees. In finding that the complaint alleged sufficient grounds to excuse the plaintiffs from not making the requisite demands, the court discussed the nature of those circumstances which would justify such a failure:

> As we are of the opinion, as above set forth, that the allegations of the complaint state causes of action against the defendant directors for acts of fraud, concealment, illegality, gross negligence, waste of corporate assets and conspiracy to conceal losses and causes of action, and as it is alleged that a majority of the Association's present Board have participated in various of the alleged acts, it is clear to us that it would be futile for the plaintiffs to make demand upon those directors to cause the Association to sue them to recover for their own wrongful injuries to

> the Association. It is well established under these circumstances that the plaintiffs, as *minority members* of the Association, are excused from the usual requirement that they make a prior demand upon the directors as a condition precedent to maintaining a derivative action.

250 Md. at ___, 242 A.2d at 545. (Emphasis added). The crucial factor in the Court's finding of justification is the fact that the members bringing suit were in a distinct minority. They were therefore completely denied recourse to any other remedy outside of equity. They thus satisfied the essential prerequisite for equity jurisdiction. In contrast, the shareholders in the instant case were a secure majority that could have obtained the sought after relief by way of normal legal remedies. Under Maryland law a majority of the outstanding shares may remove any director or directors from office and elect successors for the unexpired terms. Md. Ann. Code, Art. 23, § 52(d). This was clearly possible in the instant case and successor directors could have been chosen to prosecute these actions. Furthermore, the president of Ebony, Lawrence Purnell, was already committed to follow the commander of the stockholders.

Moreover, the Court in *Parish* pointed out specific circumstances which justified the members' failure to make a demand of the rest of the membership. The Court noted:

> That at the annual meeting of February 22, 1965, a short time after filing the suit in the present case on February 4, 1965, a resolution was allegedly passed by the majority of the members expressing confidence in the present Board and undertaking to indemnify them for the payment of

> any judgments which might be rendered against them, a resolution declared to be carried although the complainants tried unsuccessfully to be recognized and speak against it. This extraordinary action indicates the futility of requiring a prior demand on the members by the complainants.
>
> Then, too, it is alleged that the plaintiffs were refused (unlawfully as we shall later point out) the list of members, so that it would have been practically impossible for them to acquaint the membership with the relevant facts allegedly concealed from the members of the Board. This fact alone is sufficient to excuse the minority members from making prior demand upon the general membership.

240 Md. at ___, 242 A.2d at 545-546 (Citations omitted). The very opposite conditions obtained in the case at bar. A majority of the shareholders were not in sympathy with the Board of Directors and the shareholders in fact exchanged a list of shareholder addresses in order that everyone would have full access to each other. Based on the criteria of *Parish*, therefore, it seems clear that the instant case should have been decided differently. The shareholders should have been denied standing to bring a derivative action under these circumstances.

IV. THE TRIAL COURT ERRED IN AWARDING PUNITIVE DAMAGES UNDER THE CIRCUMSTANCES OF THE CASE AT BAR.

A. An Action for Damages Against An Attorney for Malpractice Is An Action Arising in Contract and Maryland Law Does Not Permit An Award of Punitive Damages in An Action *Ex Contractu.*

We begin with the basic proposition, long-recognized in the courts of Maryland, that an action against an attorney for malpractice arises in contract.

> [T]his responsibility of the attorney, although ordinarily enforced by an action of case for negligence in the discharge of his professional duties, in reality rests upon his employment by the client, and is contractual in its nature. Before the attorney can be made liable, it must appear that the loss for which he is sought to be held arose from his failure or neglect to discharge some duty which was fairly within the purview of his employment.

Watson v. Calvert Bldg. and Loan Assn., 91 Md. 25, 33, 45 A. 879, 881 (1900). See also, *Wlodarek v. Thrift*, 178 Md. 453, 13 A.2d 774 (1940); *Reamer v. Kessler*, 233 Md. 311, 196 A.2d 896 (1964); *Mumford v. Staton, Whaley & Price*, et al., 254 Md. 697, 255 A.2d 359 (1969).

Turning next to the law of punitive damages in Maryland, the recent case of *Siegman, et ux. v. The Equitable Trust Company*, (Court of Appeals of Maryland, filed December 8, 1972) reaffirms as "well-settled" the rule of law that there can be no award of punitive damages in a pure action for breach of contract, citing *St. Paul at Chase Corp. v. Manufacturers Life Ins. Co.*, 262 Md. 192, 278

A.2d 12 (1971). Thus if this action is one solely for breach of contract the award of punitive damages was in error.

From the Trial Court's finding of facts it appears that Rosenberg was found to have done no more than breach his contract at employment as an attorney, which requires the exercise of ordinary care in the execution of the business contracted to him and to a fair average of professional skill and knowledge. If the attorney does not possess as much of these qualities as he ought to possess, or having them, neglects to employ them, he becomes liable to his client for the resulting loss. *Kendall v. Rogers,* 31 A.2d 312, 181 Md. 606 (1943). For example, the lower court's finding of fact number 9 finds that Rosenberg failed to perfect a security interest in Aardvark's equipment which was a part of his duties as Ebony's corporate attorney. Finding 13 implies that Rosenberg had a contractual duty as Ebony's corporate attorney to prepare a registration statement and prospective for the Securities and Exchange Commission which he also allegedly breached. Finally there is the finding that Rosenberg erroneously advised returning some $15,000.00 to their investors. See number 22 of the Court's Finding of Facts. Clearly the first two breaches of duty found by the Court are purely contractual in nature. One arose out of a promise to perfect a security interest whereas the other arose out of a promise to prepare a registration statement. The third finding arose partly out of the attorney-client relationship but was basically a business judgment. It is true that Rosenberg acted in his capacity as an attorney in advising that the interest payments on the loans were in default and that the three investors had a legal right to demand the principal. This legal advice, however, was essentially correct. No breach of contract can be found on this advice alone.

The second part of the decision concerned the question of whether to wait for the complaining note holders to institute legal action, and thereby perhaps precipitating the collapse of the corporation, or to pay the demand in hopes of saving the corporate entity. In explaining the decision to pay off the notes Attorney Rosenberg had this to say:

BY MR. JORGENSEN:

Q. Mr. Rosenberg, I believe you stated that you felt a suit could be brought against the corporation on the notes?

A. Yes.

Q. And summary judgment could be gotten on that suit?

A. I think so because the interest payment was made, you know, late and the demand called for specifically for the acceleration, for the interest payment that was not made.

Q. At this point why was it important that there be no suits against the corporation?

A. Because I thought the whole corporation would collapse, it would stop functioning and they would be out of business very quickly. Everybody would be filing suits to get money and the corporation had a chance to live and exist if it paid the $15,000.00 back because it was working a number of aspects–in fact it was only $10,000. As Mr. Purnell said, he didn't pay $5,000 to Mr. Gershen until early in October and he worked with Mr. Gershen. He was working on these things.

Q. Was it also a factor in your consideration that the corporation still intended to go public?

A. Yes sir, all of these items were taken into

> consideration but the market was against us at this stage.
>
> (T (II) at 114-15).

Choosing to pay off these notes was essentially a business-management decision, responsibility for which rests primarily with the Board of Directors. Md. Ann. Code, art. 23, § 52(a). Moreover, even if this advice was wrong, it is well-established that neither a director, *Burkhart v. Smith*, 161 Md. 398, 157 A. 299 (1932), nor an attorney, *Busey v. Perkins*, 168 Md. 19 (1934), can be held liable for a mere error in judgment. In summary, if Rosenberg is guilty of any wrongdoing it is in the nature of a breach of contract upon which punitive damages are not allowed.

B. Even if the Principles of a Tort Action Apply, the Trial Court Made No Finding of Actual Malice as Required to Support an Award of Punitive Damages Under Maryland Law.

To sustain a verdict for punitive damages under the law of Maryland there must be a finding of actual malice. The Maryland Court of Appeals defined actual malice in *Drug Fair v. Smith*, 263 Md. 341, 283 A.2d 392 (1971), as follows:

> Actual or express malice may be characterized as the performance of an unlawful act, intentionally or wantonly, without legal justiciation or excuse but with an evil or rancorous motive influenced by hate: *the purpose being to deliberately and wilfully injure the plaintiff.*

Id. at 352, 283 A.2d at 398. (Emphasis added).

The lower court made no finding of fact which would support a conclusion of actual malice. Instead the court determined as a conclusion of law that "(D)efendant Ros-

enberg displayed an appalling lack of concern for the substantive law governing the corporation he "counseled". See Conclusions of Law No. 5. The court then found Rosenberg guilty of "gross and wilfull misconduct . . . in direct conflict with his fiduciary duties to Ebony and its predecessor, Urban, (entitling) plaintiffs to punitive damages." Conclusion of Law No. 7. None of these stands espoused by the court meets the explicit definition of the *actual* malice required to support a verdict of punitive damages under Maryland law. Nothing in these conclusions implies the slightest hint of the "evil or rancorous motive influenced by hate" as required by the Maryland case law. Nor do we find a purpose "to deliberately and wilfully injure the plaintiff" incorporated in the lower court's findings. The inevitable result of such lack of findings is a complete failure of the award of punitive damages on the grounds that the requisite actual malice was never determined.

C. Even if Such a Finding Is Implicit in the Lower Court's Decision, the Evidence Adduced at Trial Does Not Support a Finding of Actual Malice.

Maryland law has long held that *actual* malice must be found in order to justify awarding punitive damages and that a finding of implied or constructive malice can never be enough. *Damazo v. Wahby*, 259 Md. 627, 270 A.2d 814 (1970); *Safeway Stores, Inc. v. Barrack*, 210 Md. 168, 122 A.2d 457 (1956); *Heinze v. Murphy*, 180 Md. 423, 24 A.2d 917 (1942); *Knickerbocker Ice Co. v. Gardiner Co.*, 107 Md. 556, 69 A. 405 (1908). The *Damazo* case, *supra*, discusses the theory of actual malice in terms most appropriate to the case at bar. The defendant Damazo was the controlling stockholder and president of Wellaw-

brook Development Company, Inc., which held title to a high rise apartment building (Edwards Way). He was also the controlling stockholder and president of Vance Properties, Inc., which held title to a garden apartment cluster (Riggs Road). After the sale of both these properties, two brokers sued Damazo and his companies in contract for commissioner allegedly earned in proversing these sales, and sued all parties to the transactions in tort for tortious interference with these contract rights and for conspiracy to deprive them of their commissions. The lower court awarded the brokers a judgment for the amount of these commissions, nominal damages for these tort claims, and $5,000 punitive damages against Damazo personally as well as each of the purchasers.

In reversing the award of punitive damages, the Maryland Court of Appeals remarked:

> The Maryland rule is that malice in the sense of deliberate and improper violation of a known right, that is, absence of legal justification, will support an action and permit recovery of compensatory damages for deprivation of known contractual rights but that actual malice must be shown to support punitive damages. There is no evidence here to show more than that *Damazo wanted to benefit himself,* by receiving the gross purchase price without diminution for commissions and the various purchasers wanted to pay a lesser purchase price that the avoidance of the earned commissions would permit. As the Court said in the Knickerbocker case at pp. 569-570 of 107 Md. at p. 410 of 59 A., exemplary damages may be recoverable in cases of this character,

> "if, for example, there was evidence tending to show that the defendant had caused the contract to be broken for the sole purpose, and with the deliberate intention of wrongfully injuring the plaintiff, exemplary damages might be recovered, but when the object was *merely to benefit itself,* although the plaintiff would be thereby injured, there would be no more reason for allowing such damages than there would be in a suit by one party to a contract against the other for breach of it. Unless there was injury to the plaintiff by the act of the defendant, no action would lie, and therefore such action must be based on injury."
>
> The case before us differs from Rinaldi v. Tana, 252 Md. 544, 250 A.2d 533, in which we approved the imposition of punitive damages for tortious interference with contract rights. There, although the per curiam opinion does not reveal it, there was testimony in the record that the interferer had *expressed animosity* towards his sister with whose contract he interfered and had threatened and indicated a determined purpose to harm here. Judge Moore, the trial judge, found this brought the case within the holding of the Knickerbocker case on punitive damages.

259 Md. at ___, 270 A.2d at 819-20. (Emphasis added, citations omitted).

Thus the intent to wrongfully benefit oneself is not enough to support punitive damages. There must be animosity or evil intent directed at the injured parties. The purpose must be to "deliberately and wilfully injure the plaintiff." *Drug Fair v. Smith, supra,* at 352, 283 A.2d at 398.

The lower court bases its award of punitive damages on two transactions: first, the loan to Aardvark and, second, the repayment of the loans to the three New York investors. Apparently the court finds actual malice implicit in these two events. However, a close examination of the circumstances surrounding these events clearly establishes that malice was in no way a part of the motivation behind Rosenberg's actions.

The undisputed reason for making the loan to Aardvark was a chance to make a substantial profit. Rosenberg, Niedermayer and Purnell all thought it was a good investment (See T. (II) at 70; T. (I) at 108 and T. (II) at 16-17). In addition to notes covering the amount of the loan Ebony received 25,000 shares of Aardvark as a bonus. (T. (II) 17 and 71). And this motivation of windfall profit was in conformity to what was undisputably the primary moving force of all the participants in the Urban-Ebony-Aardvark enterprises. This is illustrated not only by the financial structure of the corporations (See Statement of Facts at pp. 4-5) but also by the direct testimony of Leon Laffal:

> Q. Now on what did you base your decision to make an investment in Urban?
>
> A. The possibility of making a capital gain.
>
> Q. A capital gain?
>
> A. Yes.
>
> Q. Were you aware of what the company's function was?
>
> A. Yes, sir.
>
> Q. What was it?
>
> A. The company's function was to sponsor the organization of a plan or method for a computer-type business, and to provide seed money for this operation to get started. And that was

essentially the purpose of it. Of course the investors would profit when the company went public.

Q. So the other investors were to make their profit from the company going public?

A. Yes, sir.

Q. Were they to make it from the operation of the company?

A. Hopefully. In fact, the concept was excellent.

Q. But mainly from the company going public?

A. No, sir. Well, I can't go into that, Mr. Greenburg. I was an investor just as I invest in other companies, that was my objective in investing in that particular one.

Secondly, it has a fine social purpose. But the main purpose of investing was to make a profit, as I had done with other companies; and taken losses, too, for that matter.

(T. (I) at 49-50).

All the investors were in fact "gambling" and the loan to Aardvark was just one isolated incident of the total scheme. Nothing within the circumstances of these calculated maneuvers justify an award of punitive damages against one participant to the benefit of the others. Naturally, the recipient of the proceeds of the loan, Aardvark, also stood to gain from the transaction, but the fact alone fails to justify punitive damages, inasmuch as the transfer was designed to benefit the shareholders of Ebony as well.

The return of some $15,000.00 to three investors is also cited by the lower court as justifying punitive damages. See Conclusion of Law No. 7. But the repayment

of these loans was with the intent of forestalling possible legal action to collect on notes which were already past due.

In explaining his advice to Lawrence Purnell, president of Ebony, concerning the repayment of these past-due notes, attorney Rosenberg explained:

> A. I think, I believe I told Mr. Purnell, that we had a number of alternatives, none of which were particularly satisfactory. One was to go into Chapter 11 bankruptcy because once the demand was made, these people could get, if they filed suit, could get summary judgment against the corporation on the note. That was the first one. So that we had to make a decision as to whether we wanted to go into Chapter 11 or continue the thing, just like the company was viable and solvent, because nobody else had demanded money back, and legally, they were entitled to their money back, considering the interest payment being late.
>
> (T. (II) at 112-13).

Again the testimony of Mr. Rosenberg concerning his fear of an imminent collapse of the corporation, if these note holders were allowed to sue, is especially relevant here. *See* pp. 22-23 *supra.* Taken together, it appears abundantly clear that the evil intent and purpose to injure the plaintiffs has not been demonstrated by the evidence in this case. Neither the loans to Aardvark nor the repayment of the notes amount to actual malice.

Moreover, even if Rosenberg advised returning the principal of those three notes because he feared suit against himself, this would at most amount to an intent to benefit himself, which clearly does not support an award of

punitive damages under Maryland law. *Damazo v. Wahby, supra.*

It should also be noted that the only direct testimony concerning Mr. Rosenberg's frame of mind and attitude toward the investors in Ebony came from Mr. Purnell:

BY MR. GREENBERG:

Q. To the attention – what attention did Mr. Rosenberg give the corporation?

A. Your Honor, may I induce you, sir, to let me–it is difficult to answer the question the way it is put because it is not what I want to–I will answer it but I think it is important to make some things known.

THE COURT: Well answer the question first and then you may explain.

THE WITNESS: I would rephrase that, what did Mr. Rosenberg do to the corporation, you see–

BY MR. GREENBERG:

Q. No, what attention did Mr. Rosenberg give the corporation and to your operation and to the founding of it?

A. Well the attention given by Mr. Rosenberg to the corporation was all that I requested of him.

Q. All that you requested of him?

A. All that I requested of him. We would discuss things daily and with that, I guess I would get to what I am trying to say, Your Honor.

THE COURT: What do you want to say in this regard?

THE WITNESS: Well, I have a very high personal regard for Mr. Rosenberg and during that

time we became very close friends. Mr. Rosenberg never did anything to harm me or anyone else, I don't think. When he was down in the divorce court–

THE COURT: Well I think that's all, thank you, Mr. Purnell.

(T. (II) at 5-6)

Thus, the only evidence concerning Mr. Rosenberg's motivation negates any possibility of malice. In conclusion, it seems apparent that the Trial Court erred in awarding punitive damages under the circumstances of this case.

V. THE COURT ERRED BY INCLUDING IN THE AWARD OF DAMAGES THE SUM OF $15,000.00 WHICH HAD BEEN RETURNED IN SATISFACTION OF PAST DUE NOTES OWNED BY EBONY.

The Stockholder's representative suit is a "derivative action" because the wrong sought to be redressed is a wrong to the corporation. The measure of recovery is the extent of the injury suffered by the corporation. *See Waller v. Waller,* 187 Md. 185, 49 A.2d 449 (1949); 6 Maryland Law Encyclopedia, *Corporations* §§151, 152; 19 Am. Jur. 2d, Corporations §528.

The total amount of funds invested in the Urban-Ebony venture was $91,625.11 (T. (II) at 64). The vast majority of these funds, however, was raised by way of loans. For example, out of a typical $5,020.84 investment, only $20.84 was a capital contribution, whereas the balance of $5,000.00 constituted a loan. (*See* testimony of Leon Laffal, T. (I) at 9-10). This was the same arrangement by which Daniel Simon, Arthur Zodek and Samuel Gershen invested. Of their total investment of $15,062.52,

only $62.52 represented a capital investment whereas $15,000.00 was a loan in return for which these three investors received promissory notes paying 6% interest quarterly. When these interest payments became past due, Simon, Zodek and Gershen made a demand for payment of the principal. (T. (II) at 114).

In returning a total of $15,062.52 the president of Ebony admittedly made a mistake. The $62.52 represented a capital investment which should not have been returned under any circumstances. But $15,000.00 of the amount was in payment of an outstanding debt of the corporation. It did not affect the capital account of Ebony. In fact, the $15,000.00 merely served to offset an outstanding liability of the corporation and therefore did not adversely affect the equity interest of the shareholders.

It follows, therefore, that in computing the amount of damages owed to the corporation, $15,000.00 of the award of $15,062.52 actually caused no legal injury to the corporation. Simon, Zodek and Gershen, who would have had legitimate claims to the assets of Ebony in the amount of $15,000.00, have recouped their entire investment. Thus, the total indebtedness of the corporation has been reduced by the same amount. There has been a *quid pro quo* and no legal injury to Ebony. The award of damages is therefore excessive by the amount of $15,000.00.

In advising Purnell on the return of these funds, Rosenberg specifically noted that the repayment should be limited to the amount of the principal (See T. (II) at 112). It was Purnell, in preparing and signing the checks, who made the mistake as to amount. Therefore, Purnell alone, as Ebony's president with a fiduciary responsibility to use

his best judgment in handling its affairs (*See Phoenix Sav. & Loan, Inc. v. Aetna Cas. & Sur. Co.*, 427 F.2d 862 (4th Cir. 1969), is responsible for the wrongful return of the $62.52. In addition, if the total sum of $15,062.52 is the proper measure of damages, Purnell should have been held jointly liable for its return. Since he questioned the legality of the return (See T. (I) at 152), Purnell had an obligation to refuse to return the funds until he either received the approval of the Board of Directors or until he consulted other counsel. In fact, he was advised by another attorney to seek additional counsel before proceeding any further (T. (I) at 152) and did in fact speak with some other attorneys concerning this and other matters (T. (I) at 152). In sum, if the return of these funds was wrongful, Purnell was on notice of this possibility and as an officer of Ebony had a fiduciary responsibility to its shareholders to take reasonable action in protecting their interests. This he failed to do and in so failing should be held liable to the extent of the value of the return.

CONCLUSION

This Court should grant certiorari to correct actions clearly in contravention of the Federal Rules of Civil Procedure, to correct serious misconduct amounting to deprivation of due process by the trial judge and to correct misapplication of Maryland law.

Respectfully submitted,

DONAHUE & EHRMANTRAUT

William A. Ehrmantraut,
Attorney for Petitioner Rosenberg.

APPENDIX A

UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

No. 72-2002 — SEPTEMBER TERM, 1973

Leon D. Laffal, *et al.*) Civil Action 322-70
v.)
Harvey Rosenberg, *et al.*) UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT
)
Harvey Rosenberg,)
Appellant) FILED: Feb. 12, 1974

HUGH E. KLINE
Clerk

(Handwritten):
Pet. for Cert. due 5/13/74

Before: Bazelon, Chief Judge; Wright, Circuit Judge; and Wyzanski*, United States Senior District Judge for the District of Massachusetts

ORDER

On consideration of Appellants' petition for rehearing, it is

ORDERED by the Court that Appellants' aforesaid petition for rehearing is denied.

Per Curiam
For the Court:

/s/ Hugh E. Kline
Clerk

* Sitting by designation pursuant to Title 28, U.S.C. §294(d).

UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT

No. 72-2002 SEPTEMBER TERM, 1973
Civil Action 322-70

Leon D. Laffal, *et al.*)
v.) FILED: Jan. 22, 1974
Harvey Rosenberg, *et al.*)
)

Harvey Rosenberg, *Appellant*

APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF COLUMBIA

Before: Bazelon, Chief Judge, Wright, Circuit Judge and Wyzanski*, Senior United States District Judge for the District of Massachusetts

JUDGMENT

This cause came on to be heard on the record on appeal from the United States District Court for the District of Columbia and was argued by counsel. On consideration of the foregoing, it is

ORDERED AND ADJUDGED by this Court that the judgment of the District Court appealed from in this cause is hereby affirmed, for the reasons set forth in the attached memorandum.

Per Curiam
For the Court:

/s/ Hugh E. Kline
Clerk

* Sitting by designation pursuant to 28 U.S.C. §294(d).

* * *

No. 72-2002 Leon D. Laffal v. Harvey Rosenberg, *et al.*

Memorandum

In this shareholders' derivative action, appellant, the corporation's attorney, was found liable for compensatory and punitive damages. His primary contention is that the proper standard for punitive damages was not applied at trial. Because this case involved a Maryland corporation, all parties agree that Maryland law governs this issue. We are unable to find that the trial judge misperceived or misapplied the law of that state.

We have examined appellant's other contentions and find them to be without merit. Accordingly, the judgment below is

Affirmed.

APPENDIX B

UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF COLUMBIA

* * *

LEON D. LAFFAL, *et al.*, *Plaintiffs*, v. HARVEY ROSENBERG, *et al.*, *Defendants*.) Civil Action No. 322-70) **FILED**: June 28, 1972) **JAMES F. DAVEY, Clerk**

FINDINGS OF FACT, CONCLUSIONS OF LAW AND ORDER

This is a derivative action brought by four stockholders against four directors and the corporate attorney. The matter was tried before the Court without a jury on May 8 and 9, 1972. After all the evidence was presented, the Court dismissed the claims against two of the directors. We entered an order to that effect on May 17, 1972.

Having reviewed the proposed findings and conclusions and supporting memoranda submitted by counsel, we make the following findings of fact and conclusions of law with respect to plaintiffs' claims against the remaining directors and the corporate attorney, the directors' crossclaim against the attorney, and the attorney's crossclaim against the directors.

FINDINGS OF FACT

Urban Systems Research, Inc.

1. Urban Systems Research, Inc. (hereinafter Urban), was incorporated in Maryland on September 27, 1968.

2. In September and October of that year, twenty individuals invested $91,625.11 in Urban.

3. The four plaintiffs invested a total of $15,062.52.

4. Urban did not elect officers; however, defendant Harry Niedermayer was designated president and the corporate attorney, defendant Harvey Rosenberg, was designated secretary on Urban's certificate of authority for corporate account. Niedermayer was also named as a director in Urban's articles of incorporation.

5. Urban never held a stockholders' meeting, never adopted by-laws, and was never advised that it should do so by Rosenberg.

6. Urban opened a corporate checking account at American National Bank on October 29, 1968, with an initial deposit of $62,823.01. Rosenberg and Niedermayer wrote checks on this account. The balance of the $91,625.11 was kept elsewhere.

Disbursements to Aardvark Audio Productions, Inc.

7. On November 7, 1968, Rosenberg and Niedermayer disbursed $15,000.00 to Aardvark Audio Productions, Inc. (hereinafter Aardvark), and on November 22, 1968, they disbursed an additional $5,000.00 to Aardvark. Moreover, the testimony at trial disclosed the fact that an October 30, 1968 check to Carey Winston was written to cover Aardvark's rental deposit and like charges; a November 4, 1968 check to C. & P. Telephone covered Aardvark's telephone deposit; and a November 4, 1968 check to Norman R. Cook paid Aardvark's salary obligation to Mr. Cook who was an employee of Aardvark. Thus, defendants Niedermayer and Rosenberg disbursed a total of $22,597.60 of Urban's funds to or on behalf of Aardvark during November, 1968.

8. At the time of these disbursements, both Niedermayer and Rosenberg were closely associated with Aardvark – Niedermayer as a former promoter who had raised $50,000.00 in capital investment for Aardvark and who was to receive a number of Aardvark shares for his promotional efforts, and Rosenberg as Aardvark's corporate attorney.

9. The $22,597.60 was a loan to Aardvark which was arranged by Niedermayer and Rosenberg. Rosenberg was to secure the loan by perfecting a security interest on Aardvark's equipment and proceeds. Rosenberg failed to do this and the loan was left unsecured until Rosenberg, about a year later, prepared a series of promissory notes payable by Aardvark to Ebony Systems and Management Co., Inc., the successor corporation to Urban.

Ebony Systems and Management Co., Inc.

10. Ebony Systems and Management Co., Inc. (hereinafter Ebony), was incorporated in Maryland on November 14, 1968, and qualified to do business in the District of Columbia by certificate of authority filed on April 7, 1969.

11. Upon the incorporation of Ebony, all corporate assets and obligations of Urban were transferred to Ebony. No legal merger was ever effected but the transfer of funds left Urban without assets and defunct.

12. The twenty investors in Urban were never issued Urban shares and notes. Instead, each received Ebony shares – issued at the ratio of 1,042 shares (representing $10.42 in paid-in capital) for each $2,500.00 invested in the corporation – and convertible notes bearing interest on the sums invested at the rate of six percent per annum. Thus, Ebony's assets consisted chiefly of shareholders' loans and stock purchased at a penny a share.

13. Defendant Rosenberg was Ebony's corporate attorney. He indicated his intention to prepare a registration statement and prospectus for approval of the Securities and Exchange Commission in order to make a public offering of the stock at $4.00 a share. Rosenberg's total contribution to this effort to go public was a single, handwritten yellow-tablet page.

14. Defendants Harry Niedermayer and Lawrence A. Purnell were among the directors designated in Ebony's articles of incorporation.

15. No meeting of the designated directors of Ebony was held until October 6, 1969, almost eleven months after incorporation.

16. No stockholders' meeting occurred until December 18, 1969, some thirteen months after incorporation.

17. Neither directors nor officers were formally elected, but Purnell, who had assumed the duties of president of Ebony since November, 1968, was designated as president at the October 6, 1969 directors' meeting.

18. Purnell rented offices, hired and paid employees and consultants, and prepared and submitted bids for contracts. Purnell testified that he devoted from 20 to 30 hours a week to Ebony's affairs and at the same time maintained full-time employment as a mechanical engineer at the National Aeronautics and Space Administration.

19. Despite the efforts of Purnell, Ebony failed to secure a single contract and the financial outlook for the company was indeed bleak.

Return of Funds to Certain Investors

20. On July 22, 1969, upon the advice of Rosenberg, Purnell returned over $10,000.00 to two New York investors. A third investor received $5,020.84 at Rosenberg's request on October 3, 1969.

21. Rosenberg testified that he had advised that these funds be returned because the promissory notes, calling for quarterly interest payments, were in default. Rosenberg denied that his recommendation to return these funds was prompted by a letter threatening him and others connected with Ebony with a law suit. Initially, Rosenberg denied both the threat and the letter. However, after viewing a copy of the letter dated July 18, 1969, Rosenberg admitted that he had received the letter and that it might have influenced his advice to return the money.

22. The Court finds as a fact that Rosenberg urged that funds totalling $15,062.52 be returned to the three investors because he feared that legal action would be taken against him personally if he acted otherwise.

Subsequent Events

23. On December 18, 1969, at the first stockholders' meeting, after a discussion of the financial condition of Ebony and certain unexplained actions and advice of its counsel Rosenberg, the stockholders elected plaintiff Leon D. Laffal chairman of a stockholders' investigative committee.

24. On the following day, Laffal addressed a letter to Rosenberg, requesting, *inter alia*, that he explain the return of funds to the three investors, the Aardvark disbursements, and the failure to prepare the prospectus necessary to a

credit card account; and (c) disbursed $735,97 to his secretary who was at most entitled to only $356.18 for three weeks' services (January 12 through January 30).

CONCLUSIONS OF LAW

Jurisdiction

1. The Court has jurisdiction over this action pursuant to D.C. Code §11-501.

Standing

2. Plaintiffs have standing to bring this derivative suit even though they failed to make a demand upon the directors to institute suit on behalf of the corporation. In their complaint, plaintiffs set forth their reasons for not making such demand – *i.e.*, that the act would have been futile and that the directors would not have instituted suit against themselves or the corporate attorney. After hearing the entire case, we are satisfied that plaintiffs' reasons are valid and that the circumstances warranted their bringing suit without making what would have been a useless demand upon the directors. See *Parish v. Maryland & Virginia Milk Producers Ass'n.*, 250 Md. 24, 242 A.2d 512 (1968). The Federal Rules of Civil Procedure are not contra. See Rule 23.1 which merely requires that the complaint allege "the efforts, *if any*," made by a plaintiff, "to obtain the action he desires from the directors" or "the reasons . . . for not making the effort" (emphasis added). See also 3B *Moore's Federal Practice* ¶23.1.19 (text accompanying notes 11 to 21 and cases cited therein).

3. Plaintiffs in this derivative action may properly assert claims against Rosenberg. Clearly, the corporation

public offering. The letter demanded that Rosenberg restore the above mentioned funds and disbursements, approximately $40,000.00, to the corporation, and requested his presence at an upcoming stockholders' meeting.

25. Rosenberg, by letter dated December 20, 1969, refused to explain his actions to the stockholders, declined the invitation to attend the next stockholders' meeting, and informed the committee that their demand for $40,000.00 was being turned over to his insurance carrier.

26. On December 22, 1969, Laffal wrote to the only three directors known to him. He informed them of Rosenberg's response to the stockholders' committee letter and requested that Ebony's board of directors begin winding down the affairs of the corporation by ceasing all salaries and other expenditures except rent and telephone and by gaining control of all remaining Ebony assets.

27. On January 12, 1970, at the second meeting of Ebony's stockholders, Laffal made his report, and, as a result, the corporation terminated its employees and closed its offices. Purnell volunteered to continue working without remuneration in order to settle the affairs of Ebony and his offer was evidently accepted by those attending the meeting.

28. Purnell maintained control of the American National Bank corporate checking account. This account had a balance of $5,431.65 as of January 12, 1970. Since that date the activity has consisted of a single deposit of $1,100.00 (made on April 13, 1972) and seventeen disbursements. The current balance is $138.00.

29. This checking account disclosed that since January 12, 1970, Purnell has (a) written checks totaling $2,575.00 to his attorneys for his personal defense in this action; (b) paid himself $1,404.72 to cover his Carte Blanche

has a right to sue a third party such as an attorney, and plaintiffs derive their right to sue from their equity in the corporation.

Expert Testimony

4. Under the facts and circumstances of this case, plaintiffs need not support their cause of action against Rosenberg with expert testimony. See *Central Cab Co. v. Clarke*, 259 Md. 542, 551-52, 270 A.2d 662, 667-68 (1970).

Rosenberg

5. Defendant Rosenberg displayed an appalling lack of concern for the substantive law governing the corporations he "counseled." For the misfeasances, malfeasances, omissions and improper advice which made up his "services," Rosenberg was paid $3,875.00.

6. Rosenberg was responsible for the dissipation of corporation funds totalling $37,660.12. First, in concert with Niedermayer, Rosenberg arranged $22,597.60 in loans to Aardvark and actually signed the checks drawn on the Urban account; additionally, he failed to obtain collateral security – other than mere promissory notes – for such loans. Rosenberg and Niedermayer are jointly responsible for the loss of this $22,597.60. However, Rosenberg, alone, is responsible for the preferential return of $15,062.52 to the three investors; he knew the impropriety of such an act yet urged it nonetheless.

7. Rosenberg is guilty of gross and wilfull misconduct for his direct participation in the transfer of funds from Urban to Aardvark while serving as attorney for both corporations, and his subsequent failure to obtain the promised collateral security therefor; and for his arranging the

return of investments to certain stockholders in order to avoid a personal law suit. Such pernicious activity is in direct conflict with his fiduciary duties to Ebony and its predecessor, Urban, violates the ethics of his profession, and entitles plaintiffs to punitive damages. The Court sets such damages at $50,000.00.

Niedermayer

8. As stated in paragraph 6, supra, defendant Niedermayer is jointly liable for the dissipation of $22,597.60 of corporate funds. Niedermayer was a promoter for both Urban and Aardvark, and at the time he signed the checks as president of Urban he was expecting to receive Aardvark stock for his earlier promotional activities.

Purnell

9. Purnell was very well compensated for his part-time efforts on behalf of Ebony. However, plaintiffs have failed to prove their allegation that his compensation was excessive.

10. Purnell's part in the return of funds to the three investors was blameless. He acted solely at the direction of Rosenberg who assured him that the return was not improper. Under the circumstances of this case, Rosenberg and not Purnell should be held responsible for the dissipation of these funds.

11. Purnell used $2,575.00 in Ebony funds to pay his attorneys to represent him in this action. He used check bearing the Ebony name to make these payments. Purnell also paid himself to cover his Carte Blanche credit card account. Finally, Purnell overpaid his secretary $379.79 during the month of January, 1970. None of these disbursements was authorized; they were clear violations of fiduciary duty

during the winding down period. Accordingly, Purnell is liable to the corporation for $4,359.51.

Loss of Business

12. Plaintiffs' additional claim for loss of business by the corporation due to mismanagement and lack of supervision is too speculative and is not supported by the evidence.

Cross Claims

13. Purnell and Niedermayer's crossclaim against Rosenberg is unsupported by the evidence.

14. Rosenberg's crossclaim is likewise unsupported.

Plaintiffs' Attorney's Fees

15. Plaintiffs' attorney is entitled to legal fees to be paid by Ebony and the amount will be determined by the Court upon presentation of time and expense statements by counsel.

The foregoing constitutes the Court's Findings of Fact and Conclusions of Law and an Order consistent herewith is entered this date.

/s/ John H. Pratt
United States District Judge

June 28, 1972

B. 11

UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF COLUMBIA

LEON D. LAFFAL *et al.*, Plaintiffs,	)	
v.	)	Civil Action No. 322-70
HARVEY ROSENBERG *et al.*, Defendants.	)	

ORDER

Upon consideration of the foregoing Findings of Fact and Conclusions of Law it is, by the Court, this 28th day of June, 1972,

ORDERED, that the corporate defendant, Ebony Systems and Management Co., Inc., be and the same hereby is awarded judgment against the defendants in the following amounts:

(1) The sum of $22,597.60 against the defendants Harvey Rosenberg and Harry Niedermayer, jointly and severally, plus costs and interest from the date of this Order;

(2) The additional sums of $15,062.52 compensatory damages and $50,000.00 punitive damages against the defendant Harvey Rosenberg, plus costs and interest from the date of this Order; and

(3) The sum of $4,359.51 against the defendant Lawrence A. Purnell, plus costs and interest from the date of this Order.

IT IS FURTHER ORDERED that the defendant Rosenberg's cross claim against the individual defendants and the individual defendants' cross claim against Rosenberg are hereby denied.

/s/ John H. Pratt
United States District Judge

June 28, 1972

B. 12

United States Court of Appeals

FOR THE DISTRICT OF COLUMBIA CIRCUIT

No. 72-2002

September Term, 19 73

Civil Action 322-70

Leon D. Laffal, et al.

v.

Harvey Rosenberg, et al.

Harvey Rosenberg,
Appellant

FILED
FEB 12
HUGH E. KLINE
CLERK

Before: Bazelon, Chief Judge; Wright, Circuit Judge; and Wyzanski*, United States Senior District Judge for the District of Massachusetts

ORDER

On consideration of Appellants' petition for rehearing, it is

ORDERED by the Court that Appellants' aforesaid petition for rehearing is denied.

Per Curiam
For the Court:

Hugh E. Kline
Clerk

*Sitting by designation pursuant to Title 28, U.S.C. §294(d).

United States Court of Appeals

FOR THE DISTRICT OF COLUMBIA CIRCUIT

No. 72-2002 September Term, 1973

Civil Action 322-70

Leon D. Laffal, et al

v.

Harvey Rosenbery, et al

Harvey Rosenbery, Appellant

APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF COLUMBIA

Before: Bazelon, Chief Judge, Wright, Circuit Judge and Wyzanski,* Senior United States District Judge for the District of Massachusetts

JUDGMENT

This cause came on to be heard on the record on appeal from the United States District Court for the District of Columbia and was argued by counsel. On consideration of the foregoing, it is

ORDERED AND ADJUGED by this Court that the judgment of the District Court appealed from in this cause is hereby affirmed, for the reasons set forth in the attached memorandum.

Per Curiam
For the Court

Hugh E. Kline
Clerk

*Sitting by designation pursuant to 28 U.S.C. § 294(d)

United States Court of Appeals
for the District of Columbia Circuit

FILED JAN 22 1974

HUGH E. KLINE
CLERK

No. 72-2002 Leon D. Laffal v. Harvey Rosenberg, et al

Memorandum

In this shareholders' derivative action, appellant, the corporation's attorney, was found liable for compensatory and punitive damages. His primary contention is that the proper standard for punitive damages was not applied at trial. Because this case involved a Maryland corporation, all parties agree that Maryland law governs this issue. We are unable to find that the trial judge misperceived or misapplied the law of that state.

We have examined appellant's other contentions and find them to be without merit. Accordingly, the judgment below is

Affirmed.